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DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-SETH SEARLS AND JWEEKS
SINGAPORE FOR SBAKER
TOKYO FOR MGREWE
COMMERCE FOR 4430/KELLY
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR TCURRAN
DEPARTMENT PASS EXIM BANK
USDA/FAS/OA YOST, MILLER, JACKSON
USDA/FAS/OCRA CRIKER, HIGGISTON, RADLER
USDA/FAS/OGA CHAUDRY, DWYER

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TAGS: EFIN EAGR ECON PGOV ID
SUBJECT: INDONESIA: DIVERGENT VIEWS ON IMPACT OF GLOBAL ECONOMIC
INSTABILITY

¶1. (U) Summary: The U.S. economic downturn will decrease Asian economic growth prospects, according to Morgan Stanley Asia Chairman Stephen Roach, who spoke to Indonesian business executives on March ¶31. Lower U.S. consumption will likely reduce Asian exports to the U.S., a significant driver of growth. Roach also warned that growing protectionist sentiment in the United States could result in higher world inflation and tighter monetary policies. In contrast, the World Bank Chief Economist for East Asia predicted only a modest slowdown in the United States and limited impact on Asia. Both economists raised concerns about the severe effect of rising food prices on the world's poor. Nehru warned governments not to respond with market distorting price controls and subsidies. Indonesia's large domestic economy and diversified export base reduce the repercussions of a global economic slowdown, but poverty and the risks to economic growth are rising. Recent bond and equity market movements in Indonesia reveal increased investor concern. End summary.

Morgan Stanley: Worst yet to Come

¶2. (U) The simultaneous collapse of the housing and credit markets in the United States will lead to a prolonged period of economic retrenchment in the United States and around the world, according to Morgan Stanley Asia Chairman Stephen Roach. Roach identified three rounds of impacts: the first in financial markets, the second in U.S homebuilding and consumption, and the third in reduced growth in world trade and capital flows. According to Roach, the first-order impacts may have reached their peak, but the second and third round effects will pull down world growth for the next few years. Easy credit access and the wealth effect of higher housing prices spurred unprecedented U.S. consumer spending in recent years, Roached noted. U.S. wages have grown at a significantly slower pace than consumption for the past five years.

¶3. (SBU) Roach rejected both decoupling - the notion that Asia will be unaffected by a U.S. economic slowdown - and the theory that consumption in China and India could compensate for significantly

lower U.S. consumption. Growth in Asia as a region over the past twenty years has been dependent on exports, particularly to the United States, according to Roach. Exports comprise 45% of GDP in Asia in 2006, compared to less than 20% in 1980. In 2006, 21% of China's exports, 23% of Japan's exports, and 14% of ASEAN's exports went to the U.S. Roach said that Japan will enter a recession soon, given the high proportion of Japanese exports destined for the United States. While intra-regional trade and internal consumption are rising across Asia, these sources of growth are relatively small when compared to the United States market. Combined personal consumption in China and India in 2006 was less than $2 trillion, while annual U.S. personal consumption was more than $9 trillion.

¶4. (U) Roach's greatest concern is that the current economic crisis in the U.S. will result in a new era of anti-globalization, characterized by protectionist trade policies, which prompt higher inflation and interest rates and lower investment returns. Labor compensation as a share of national income has remained steady or declined over the past ten years, despite significant gains in productivity, lending support to views that globalization has not improved the lives of average people. High oil and food prices also put pressure on middle- and low-income households around the world, and have already prompted governments to erect trade barriers. While Roach anticipates a decrease in world oil and mineral prices over the next year, he predicts agriculture prices will remain high due to demand from emerging markets and alternative energy producers.

World Bank: Asia positioned to weather the storm
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¶5. (U) World Bank Chief Economist for East Asia Vikram Nehru expects the United States economy to recover over the next 12-18 months and believes the United States' economic problems will have a minimal affect on Asian growth rates. Asia's high savings rates, strong

productivity growth, large current and capital account surpluses, and fiscal capacity to respond to slower export growth will provide a sufficient cushion to absorb slower U.S. demand for Asian exports. In contrast to Roach, Nehru said that the importance of the U.S. to world growth has receded significantly. U.S. share in world imports dropped from over 18% in 1999 to roughly 15% in 2005, while developing countries outside Asia now consume more than 20% of world imports. Nehru believes that domestic demand will be a key force behind economic growth in Asia.

¶6. (U) Rising global food prices are a serious risk to Asia and the world, according to Nehru. High food prices could erase the reduction in poverty in the region achieved over the past 20 years of high economic growth in Asia. Asian governments must avoid widespread use of price controls and subsidies to dull the impact of high global prices. These policies tend to be regressive, lead to significant economic distortions and encourage black market activity, according to Nehru. Instead, Nehru encouraged governments in Asia to use progressive policies, such as targeted cash transfers to the poor, which directly improve the purchasing power of low-income households.

Indonesia: Risks Increasing

¶7. (SBU) Indonesia's large domestic economy and diversified export base reduce its vulnerability to a significant slowdown in world growth. However, risks to economic performance are rising, based on Morgan Stanley and World Bank analysis. High food prices are straining household budgets and contributing to higher overall inflation rates, which will curb domestic consumption. Indonesian headline inflation jumped to 8.17% in March, as food, tobacco, and clothing prices soared. If metal and mineral prices decline in line with Roach's predictions, Indonesia's export growth rate could slow markedly. In addition, while only 11% of Indonesian exports go directly to the United States, 13% of the country's exports go to Japan, which is also facing slower growth, reducing the scope for growth in Indonesian exports. Indonesia also has less flexibility to respond to declining internal and external demand with expansionary fiscal policy. The overall subsidy bill - estimated at 25-30 percent of the overall budget - has reduced the scope for

other spending.

¶8. (U) Investor concern about Indonesia is mounting, according to an April JP Morgan report. A growing number of asset managers are nervous about the ability of the Indonesia government to maintain the FY08 projected budget and funding plan in light of increasing fuel subsidies. The 10-year local bond price has decreased by 9% since the end of February. The Jakarta Composite Index also declined this week on concerns that Bank Indonesia will maintain interest rate levels despite growing inflation, raising the risk of negative real interest rates, which could prompt an exodus of "hot money." JP Morgan analysts have recommended that investors reduce holdings in banking institutions with large exposures to the consumer market or large bond portfolios.

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